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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	CC Docket 94-1
Price Cap Performance Review	)	
for Local Exchange Carriers	)	

Reply Comments of the INTERNATIONAL COMMUNICATIONS ASSOCIATION

Introduction and summary

The International Communications (ICA) hereby replies to initial comments submitted by other parties on May 9, 1994, concerning the Notice of Proposed Rulemaking in the matter captioned above (FCC 94-10, February 16, 1994). The ICA is the largest association of telecommunications users in the world. Recent estimates indicate that ICA members spend about $21-billion each year on telecommunications services and equipment. Therefore, ICA's members are vitally interested in the Commission's assuring that the LEC price cap plan offers adequate incentives for improved efficiency among local exchange carriers and rates that reflect the declining costs of new technologies being utilized by LECs. Both of these objectives are vital and both demand the same result: The LEC plan must be strengthened in ways that will prevent LECs from earning windfall gains merely because the Commission was overly cautious in setting the initial X-factor or productivity offset, which the initial comments demonstrate to have been set far too low initially.

Accordingly, ICA renews the call we made in our initial comments that the Commission require LECs to make a one-time 3% adjustment to rates to account for the initial X-factor specification error. As we suggested, the one-time adjustment could be applied pro rata to each LEC's services across the board, or it could be

applied specifically to common line and residual transport interconnection rate elements. A 3% one-time adjustment is warranted to account for, in effect, the overstatement of LEC rates under the initial plan, but it only addresses the final year of the plan. Three percent represents the difference between the prescribed X-factor of 2.8% and an X-factor of 5.8%, and 5.8% is the midpoint of various LEC-sponsored total factor productivity calculations since 1984 and the calculations submitted by major ratepayers. ICA is not requesting the Commission to go back and reopen the price cap calculations of the LECs for the first three years of the plan. While it might be appropriate to revisit the initial X-factor calculations, re-specifying the X-factor for the fourth year, in the form of a one-time additional rate decrease to be effective July 1, 1995, is the minimum remedy to prevent LECs from realizing further windfall gains at ratepayers' expense.

ICA has carefully reviewed the comments filed by the major LECs and other parties to this proceeding, with respect to this issue and other major points. Based upon this review, ICA urges the Commission to act as follows:

Competition for LEC services (Transitional Issues)

- The LECs submitted voluminous material attempting to show that interstate access services are effectively competitive. The Commission should give little weight to this information, however, because of its indirect, anecdotal character and because it entirely fails to reflect real barriers to the expansion of competition.

- ICA believes that the Commission should begin to collect market share data, on a strictly confidential basis, from any common carrier serving parts of the local telecommunications and access service market in particular geographic regions. The LECs' notion of "addressability" is not an appropriate measure of the competitive potential of the market, because it fails to reflect the demand-side barriers to local competition. Addressability might someday provide a useful *supplemental* measure of competition, but only after existing legal, unequal interconnection and number portability barriers to customers' selection of entrants are eliminated.

Adapting price caps to developing competition (Issues 3 and 8).

- The Commission should treat this review of LEC price caps mainly as the beginning of the evolution of the plan, rather than the opportunity to make the massive reductions in regulatory oversight that the LECs seek. ICA believes that if the changes we recommend in the LEC price cap plan are adopted, the plan can become a more evolutionary policy instrument that is changed as competition increases and as the Commission obtains information showing that a better balance has been struck between ratepayers and dominant local exchange carriers. An important change is to adopt the price linking mechanism for "new" services that ICA sponsored in our initial comments. Under appropriate conditions, the basic plan could be extended beyond a second four-year period, reinforcing its incentive effects on LECs.

Infrastructure stimulus (Issues 1 and 2)

- The Commission should dispense with further consideration of upward adjustments in price caps in order to provide funding for telecommunications infrastructure, even the limited funding program that ICA outlined in Attachment A to our initial comments. The LECs have entirely failed to provide any economic demonstration that the price cap plan should be tilted in their favor, in order to provide a supply-side stimulus to the telecommunications infrastructure. Other comments clearly show that imposing an infrastructure "tax" on ratepayers would create a deadweight loss in the economy.

LEC productivity (Issue 3)

- In addition to imposing the one-time rate decrease noted above, the Commission should base its determinations in this area exclusively on LEC productivity data since divestiture. Both direct and indirect measures of LEC productivity over the last ten years show that the average productivity factor should be between 5.7% and 5.9% even before any productivity stimulus is added. The LECs have failed to show that the last ten years' experience with the effects of computer-based technologies on local telecommunications should be ignored in favor of conditions going back 30 to 50 years.

- ICA believes that the Commission should move towards use of direct total factor productivity measures, as some LECs advocate, but only if actual LEC input prices are calculated. Using direct TFP measures will ensure that the productivity factor discussed above is sustainable in the future.

Structural features of the LEC plan (Issues 4, 5, and 6)

- Several structural features of the initial LEC price cap plan were developed as ways of checking whether the plan was structured appropriately and struck the correct balance between ratepayers and local telephone companies. These features include earnings sharing, the common line formula and the treatment of exogenous costs. While some of these structural checks may be relaxed, it is premature to eliminate earnings sharing backstops. Earning sharing should be continued in order to assure that the revised price cap plan has struck a correct balance between ratepayers and dominant local exchange carriers. Earnings sharing should be discontinued only when there is direct evidence that LECs' earnings gains in the sharing range as the legitimate product of their own cost-cutting efforts towards innovation, rather than by sheer mis-specification of the plan itself.

Service Quality (Issue 7)

- ICA believes that the Commission should continue to address LEC service quality and network reliability outside the actual price cap plan. This approach will allow the Commission to maximize the effectiveness of the Network Reliability Council while also assuring that LEC service quality improves over time through the use of benchmarks and other indicators of best practices regarding service and transmission quality.

Competition for LEC services (Transitional Issues).

In its comments, USTA observes that "local exchange carriers cannot be expected to provide information about the capabilities of their competitors".[1] As if to prove this point, USTA and most of the other LECs attached to their comments extensive lists, maps, press releases and other documents that do not, in any sense, support their view that the market is effectively competitive.[2] A simple test illustrates why this is so. The Commission may ask the hypothetical question "If non-LEC competition was suddenly outlawed, what aspects of the LECs' data on competition would become irrelevant?" The answer is: None of it, because the information does not really address the competitive state of the market in the first place.

Non-LEC competition is not outlawed at the federal level, although, as several comments note, it still is prohibited in the vast majority of state jurisdictions. But if, hypothetically, competition were suddenly outlawed, all of the LECs' lists of "strategic ventures," of "companies in buildings passed by CAP facilities," the LECs' maps of the relative traffic density of different exchanges, and their maps of where competitors have facilities in place would still be just as accurate as before. And just as useful. The point is that all of the LECs' proffered "information" on competition does not measure the ability of competitors to check the dominant LECs' market power.

Reading all of the initial comments, it is clear why the LECs have attempted to demonstrate that competition exists by supplying such voluminous, detailed but ultimately irrelevant information.[3] Actual competition today is quite slight and there

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[1] USTA Attachment 9, "CMA Demonstration and Data Reporting Requirements," p.1.

[2] *See*, for example, Ameritech comments, pp. 9-11, attachment to Ameritech Comments, "High Capacity Services in the Ameritech Region, Fall, 1992;" Bell Atlantic comments, pp. 4-5 and Attachment A "Affidavit of R. E. Beville;" BellSouth pp. 21-31; NYNEX, pp. 13-18 and 20-22; GTE, pp. 22-25 and 27-37; Pacific Telesis, pp, 92 et. seq. GTE comments, Attachment B "Strategic Alliances and Mergers," and Attachment C "CAPs Operating in GTE's Territory;" Southwestern Bell comments, Appendix "Comp" "Demonstration of Competition in SWBT's Access Markets;" and BellSouth Comments, Tab 2, "Competitive Assessment."

[3] A number of LECs include data and or studies conducted by Quality Strategies, Inc. *See* Ameritech comments, Attachment B; NYNEX comments, Attachment A; Pacific Telesis, pp. 75-76. This firm provides market research data as well as information from its own surveys of telecommunications users, some of which are ICA members. The LECs have not included in their data the actual survey documents Quality Strategies used to estimate market shares for LECs like

remain many *de jure* and/or *de facto* barriers to the extension of competition. State laws, rules and practices that forbid or limit competition constitute some, but not all, of these barriers. There are a host of unresolved issues with respect to equality of access and full interconnection even at the federal level. Thus, it is simply premature for the LECs to seek reduced regulation based upon their perceptions of competition. As ICA indicated in our initial comments, the LEC price cap plan should be restructured in several ways which, if done right, will create a system having sufficient elasticity to *adapt to* competition if, as and when it develops.

In the remainder of the quote from USTA's Attachment 9, the LECs suggest "that the Commission must collect data on an ongoing basis from all market participants." ICA believes this observation is essentially correct, but that the Commission should endeavor to collect actual market share data, rather than relying upon the LECs' subjective concept of addressability. As AT&T did ten years ago, in a much earlier stage of its competitive evolution, the LECs denigrate measures of actual market shares. In truth their position is motivated by the fact that actual market share data strongly contradicts their position. It is true that current economic practice holds that market share is not the ultimate indicator of market power.[4] But market shares are still extremely useful benchmarks of the state and *growth rate* of competition, in a market like the LECs' where entry occurs against the historic condition of monopoly dominance. In particular, ICA believes that the changes in an LEC's and its competitors' market share will prove to be quite useful to the Commission for a number of years to come. Market share should be used to measure the performance characteristics of the local telecommunications, even if it is not the definitive measure of market structure.

While the LECs argue that competition should not be measured by market shares at all, they have submitted much information about the *quantities* of facilities that they believe to represent competition. In effect, the LECs will rely upon estimates of quantities of the supposedly competitive services, they just do not want these

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Pacific. However, some surveys are conducted by asking users questions such as "Who provides your access services." If the customer answers, for example, Sprint, MCI or AT&T the survey process may not be able to determine that the actual *underlying service is provided by the LEC*, and thus should properly be counted as part of the LEC's market share.

[4] That is, it is too simplistic to find that a market share greater than "x" percent proves market power or that a firm's share of less than "y" percent demonstrates the absence of market power.

quantities to be compared to *their own demands*, in the form of market share calculations. They want the Commission to look only at the numerator, not the full size of the denominator. One LEC consultant, for example, notes the increasing use of VSAT terminals (satellite dishes) by business, estimating that the number of such terminals has increases from 67,000 to 109,000.[5] What this type of information misses, however, is a comparison with the dominant LECs' own market base. VSATs are substitutes for terrestrial data circuits, usually at data speeds of 9.6 Kbps or greater. LECs, of course, control a large share of the data circuit market by means of both analog and wideband (1.544 Kbps and above) special access and local circuits. ICA estimates that LECs provide 1.05-million to 1.2-million access circuits in just the 9.6- to 64-Kbps digital data speed. Therefore, the number of VSAT terminals cited by the LECs amounts to less than 10% of even this *limited* LEC segment of the overall market for data circuits.

Therefore, rather than relying upon LEC estimates of a part of the market, the Commission should collect real market share information as the primary benchmark of the rate at which local and interstate access competition actually develops. The costs to collect actual market share information are relatively low. The Commission can require market participants to file straightforward data on a limited number of measures of market share, e.g., billed minutes of use of switched services, DS1-equivalent connections and, perhaps, revenues. A significant barrier to competition is the current inability of entrants to offer, or users to buy, combined interstate access and local services due to state-level prohibitions. Therefore the market share data should include all traffic that could be carried over an LEC's or a competing firm's facilities, even if local carriage is precluded by *de facto* or *de jure* conditions. The data can be collected from all entities that hold themselves out as common carriers, indifferently serving customers in various geographic areas where they do business.[6]

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[5] USTA comments, Attachment 2, Harris, "Economic Benefits of LEC Price Cap Reform," at pp. B-8 to B-9; cited in USTA comments, p. 39. Southwestern Bell, among individual LECs also cites the growth of VSAT terminals to prove "competition."

[6] Omitting market share data from other sources, such as private transmission systems, will not significantly distort the common carrier market share data or reduce its value to the Commission. As the VSAT example above illustrates, non common carrier facilities are relatively minuscule in comparison to networks operated by full fledged telecommunications companies. Increasingly, moreover, large users like ICA members are eschewing reliance on non-common carrier facilities. "Being your own Bell" as it was referred to in the 1980s adversely impacts cash flow and creates high operating costs than doing business with telecommunications companies. Technological obsolescence and other risks, such as radio spectrum displacement, have proven to be greater with

Under current FCC practices, these data might be submitted only in electronic formats. The carriers involved likely would seek to have these data submitted on a redacted, confidential basis. ICA would not object to the Commission's imposing rigorous confidentiality requirements on the data, because the purpose of such submissions would not be to provide full public information. Rather, the purpose would be to permit the Commission to make meaningful, ongoing assessments of the state and growth of competition and the effectiveness of federal and state policies on competition.

Another purpose for collecting uniform, confidential market share data is simply to reduce the incentives of LECs and competitors alike to submit indirect, anecdotal, subjective, self-serving and otherwise inadequate information regarding the development of competition — as most LECs have tried to do in their May 9 comments. In our initial comments, ICA emphasized the need to examine the extent of competition in terms of an objective measurement like the number of circuits interconnected by competing local carriers with the facilities of dominant LECs.[7] In both of these recommendations, it is ICA's intent that the Commission should have objective, independent data on the extent of competition among common carriers providing local and interstate access. The need to have this information probably outweighs, at this time, the question of how it would be used precisely to provide a trigger indicating effective competition. That is, it is more important to define and begin to collect the information than it is to decide if the competitors' market shares of say 10%, 25% or 50% actually establish a market as competitive.

ICA opposes the LECs' suggestion that the state of competition should be measured primarily by "addressability." Addressability is a subjective notion regarding the alleged ability of a competitor to offer services. According to the LECs, addressability might be, based upon, for example, the proximity of the competitors facilities to potential customer locations. In the longer run, a measure of "addressability" might provide useful supplemental indicator of competitive potential, but it cannot be a substitute for actual market share indicators of the type we discussed above. "Addressability" as the LECs conceive of it might be a supplemental indicator of

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private systems. Most ICA members and other businesses agree that they should focus resources on their own business and not try to be mini-telephone carriers.

[7] ICA comment, p. 11.

competition once the appropriate conditions underlying equality or access and full interconnection are achieved within a specific geographic region. Entrants such as Teleport and MFS Communications have specified discrete and well-focused lists of equal access and interconnection conditions.[8] Once such conditions are a reality, addressability may take on some relevance regarding the potential effectiveness of competition. Until such conditions exist, however, addressability is relatively meaningless.

Actual market shares better reflect the end users' actual responses to competitive entry than does the concept of "addressability." Addressability, alone, completely overlooks actual purchases from entrants by customers such as ICA's members. Therefore, addressability ignores or disguises the effects of interconnection rates, terms and conditions on the ability to effectively purchase competing services. In reality, ICA members report that these factors are important in their evaluation of potential competitive alternatives. The LECs see addressability in terms of some degree of physical proximity between competitors facilities and end users. But in reality, the effects of the competitor's cost of running a "drop" to an actual customer may be quite significant in the actual economic evaluation. Addressability ignores this cost factor, as well as potential barriers to extending the entrant's own facilities based upon limited access to rights of way, conduit and pole attachment space and access to buildings.

Addressability also ignores the effects of LEC responses to mere competitive entry. If, as some of the LECs' consultants suggest, competitive entry is not efficient, then the longer run changes in actual market shares will provide the Commission with a much more useful indicator of sustainable competition.[9] The entrant's market share at one point in time might decline later on if (a) LECs really are more efficient and (b)

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[8] *See*, e.g., MFS Comments, pp. 46-49.

[9] ICA fails to see how the argument that dominant LECs may be more efficient can be analyzed until such time as barriers in particular states to competitive provision of local telecommunications services have been largely removed. For example, much of the premises of the USTA paper by Richard Schmalensee and William Taylor is premised upon assumptions by LEC efficiencies that (a) overlook current market limits and (b) are not otherwise quantified. Dominant LEC efficiencies, if they exist, are rooted in the economies of scale and scope derived from the joint provision of many local and interstate access services. Until entrants have equal opportunity to address all market segments and attempt to exploit the same economies, the relative efficiencies of dominant LECs and the new competitors are both unknowable and irrelevant.

longer-run competitive responses by the LECs exploit that efficiency (as opposed to exploiting their market power through unreasonable price discrimination). Most major LECs already have much more ability to price flexibly and to respond to competition than the dominant long distance carrier enjoyed at a comparable point in the development of competition in that market. The LECs' pricing flexibility extends to both interstate services and intrastate services, where important business services like Centrex are generally allowed to be priced at increment costs. In many state major LECs now offer the equivalent of "off-tariff deals." Additionally, the LECs themselves are long trumpeted some customers' desire for "one stop shopping." The relative abilities of entrants and the dominant LECs to satisfy such demand may have effects on achievable market share, but, like all the other factors we mention, would not be captured at all merely by measuring "addressability."[10]

Adapting price caps to developing competition (Issues 3 and 8).

The LECs' inadequate treatment of the real competitive state of the local telecommunications market areas is their premise for several other claims. The LECs want the Commission to "simplify" the price cap plan by reducing the number of baskets, adopting the USTA proposal to define three types of "market areas" and reducing regulation of new services. ICA believes most of these requests are premature. However, with proper modifications of the plan, it is possible to foresee an evolution in which some of these features can be addressed in the future. As in the case of the Commission's modifications to the LEC price cap structure to implement the re-pricing of transport services,[11] these evolutionary changes may be best undertaken in specific future proceedings. While ICA believes it is premature at this time to conclude that another full-scale review of the LEC plan in four years is not needed, it may be that these series of evolutionary modifications will eliminate the need for review. If these conditions do occur, the revised price cap plan could, in fact, persist for the longer period of time, eight to ten years, as some LECs suggest is an

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[10] It is remarkable that, given the vast time and resources that the Bell companies are now devoting to efforts to enter long distance markets, the LECs' information purporting to depict competition fails to consider the effects of such a major potential change in market structure. The Commission should not ignore such possibilities, however.

[11] Transport Rate Structure and Pricing, CC Docket No. 91-213, *Second Report and Order*, January 31, 1994.

appropriate period to reinforce incentives.[12]

Baskets. Most LECs argued that the number of price cap baskets and subcategories should be reduced immediately, and many include charts that purport to show how the basket structure has become more complicated.[13] What the LECs neglect to mention, however, is that most of this added "complexity" as occurred due to developments that directly aided the LECs themselves. Additional baskets and categories were added to reflect the creation of the 800 database service and the zone pricing densities for transport services. The LECs were, of course, vigorous proponents of both of these changes. Therefore, ICA believes that the current structure of baskets and categories should not be changed.

Market areas. Most LECs enthusiastically endorsed the USTA proposal to develop Initial, Transitional and Competitive Market Areas.[14] USTA's primary support for this concept is contained in Attachments 4 and 9 to its comments.[15] Attachment 4 contains a generalized endorsement of the USTA proposal, but it is largely an abstraction that fails to consider the practical limitations on the proposal. We see no conceptual problem with the idea that LECs should be able to try to identify the geographic areas that the LEC believes to be subject to effective competition for local and access services. As a threshold matter, the Commission might even allow an LEC to self-designate the particular areas it believes are subject to competition. The LECs' freedom to dictate market structure should end there, however.

It is the Commission's obligation to determine through its own, independent means that meaningful triggers for effective competition have been satisfied in the areas

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[12] *See* "Regulatory Reform for the Information Age" by Strategic Policy Research January 11, 1994 (appended to several LEC comments), at p. 19; BellSouth comments, pp. 44-45. As we discuss below, the most important consideration with respect to extending the price cap plan for a longer period of time is the plans overall robustness. Therefore, a precondition for extending the plan is setting an appropriate productivity factor and extending earning sharing, at least from some interim period, to check that the revised productivity offset is sufficient.

[13] *See*, e.g., GTE comments, pp. 7-9.

[14] *See*, e.g., Pacific Bell comments; Southwestern Bell, pp. 80-85, 87; US West pp. 12-14 and 30-33.

[15] Schmalensee and Taylor, "Comments on the USTA Pricing Flexibility Proposal" and the "Competitive Market Determination, *supra*, footnote 1.

selected by LEC. Calculations of actual market shares, changes in market shares over time, and the number of interconnected circuits between the dominant LEC and competitors may all be valid triggers, as long as the decision is controlled by the Commission and not by self-interested LECs. USTA's proposal would allow the LEC to "demonstrate that [the competition] standard has been met through the submission of Requests for Proposals, affidavits from customers or similar evidence"[16] as well as maps and other variants of information that may have no bearing on its actual market power. In addition, the overall proposal is rests primarily on "addressability" which is, as ICA has shown, an inadequate standard. USTA's Attachment 9 essentially fails to address the range of factors that the Commission correctly identified in paragraph 95 of the *Notice*.

USTA wants the Commission to endorse precisely the type of "competitive showings" that individual LECs have included in their own comments.[17] As ICA indicated, those "showings" do not really prove anything. This approach would create "regulation via trade press releases." Anytime a potential competitor announced an intention to enter a market, or stated that it had constructed a few miles of fiber optics lines, anytime any group of firms offering computer, video, information or telecommunications trumpeted any sort of "strategic venture," a LEC would be able to leverage the resulting press releases into regulatory relief. History shows, however, that even in effectively competitive markets these ventures, collaboratives and entrepreneurial initiatives frequently have little or no effect (beyond issuance of the press releases). To use such non-events as evidence sufficient to de-control prices offered by long-time monopolists is nonsense. Therefore, while ICA would not oppose LEC *proposals* as to whether certain geographic areas are competitive, the actual determination of competitive status should remain firmly in the Commission's hands and be based upon objective, quantified non-anecdotal information.

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[16] USTA comments, Attachment 9 at footnotes 23 and 30. One must question what the issuance of a RFP means if there is only one proposal submitted.

[17] Another purpose of USTA's submission on data reporting requirements is apparently to encourage the Commission to erect as many administrative barriers to competitive entry as possible, by requiring entrants to supply their own maps and other spurious documentation. USTA overlooks the fact that such traditional regulatory requirements were imposed on LECs precisely because they held economic and usually legal monopolies for telephone services. LECs could, and did, build the costs of these requirements into their monopoly revenue requirements. Neither condition has any application to local telecommunications entrants.

New services. Most LECs also complained about the rules affecting their introduction of new services, including the need to obtain waivers of Part 69 rules, the unsettled nature of how the Commission examines overhead loading, risk factors and other cost elements. GTE complains generally that the Commission's processes involve "overly detailed review."[18] ICA commented initially that these issues required a more sophisticated and robust solution,[19] and continues to believe that the LECs' proposed solutions are not adequate.

ICA does agree generally with the observation by USTA that there will be increasing demand for customer-specific, application-specific telecommunications solutions.[20] The capabilities of advanced telecommunications and information technologies are sufficiently flexible that customers will seek to develop specific applications for their firms. ICA members already are experiencing this trend. The specific applications for telecommunications services are becoming more differentiated even among different firms in the same industries. Whereas most users never wanted to be "their own Bell," as a catch-phrase of the 1980s once recommended, even firms that once tried to adopt private telecommunications facilities now seek technology platforms from common carriers that can be configured to support different applications. This trend holds true regardless of whether dominant incumbents or entrant competitors are being considered.

USTA and other LECs, however, overlook the key public policy issue raised by the increasing demand for application-specific telecommunications packages: How is a regulator to differentiate between a truly customer-driven specific telecommunications solution and a service offering that is designed by the dominant LEC to limit the service's general availability, foreclose resale or is otherwise designed so as to increase unreasonable price discrimination? The answer likely is that the regulator will not usually be able to make this distinction precisely. Against this background, ICA's proposed price linking mechanism is designed as a partial substitute for the Commission's current treatment of new services, or the treatment proposed in the

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[18] Ameritech comments, pp. 22-26; BellSouth, pp. 60-65; NYNEX pp. 41-46; Pacific Telesis pp. 60-65; Southwestern Bell, pp. 31-32 and Appendix "NS;" US West, pp. 51-55; GTE comments, pp. 10-11.

[19] ICA Comments, pp. 19-22, and Attachment B.

[20] USTA comments pp. 31 et seq.

Notice.[21] The proposal is an extension of a principle recognized by even LEC consultants, that "the structure of prices in a competitive market should, if anything, be replicated in non-competitive ones" and that "the zone of reasonableness for pricing flexibility is invariant with respect to the degree of competition."[22]

The price linking mechanism betters emulates market conditions when most segments are more or less equally competitive — unlike local telecommunications today. The extension of competitive rates into all market segments often leads to reduced cash flow, at least temporarily. This is the result of the Commission's rate setting for cable television companies and the result frequently experienced by firms in fully competitive markets: Lower earnings, writedowns and charges against earnings. Recently, under the pressures of increased global competition and economic downturns adjustments in the value of competitive firms have been very common. In the 1990-93 period, 32 of the 50 firms that make up the Dow-Jones industrial and transportation stock indexes — almost two out of every three — took restructuring charges that reduced their balance sheet assets. Other firms spun off or sold off unprofitable businesses in ways that did not require accounting charges.[23] The full value of such charges amounted to over $27-billion. A few of these charges reflected unusually distressed situations in automotive, computer and airline firms. Excluding these situations, there were still over $18-billion in restructuring charges, having an average value of $1.86 per share by the other 29 firms.

Under ICA's proposed price linking treatment for new services LECs' efforts to engage in unwarranted price discrimination will have effects in all market segments. Any new services tariff filing could be subjected to initial tariff review as currently performed by the Commission staff, to ensure that a filing was not unlawful on its face. The rules governing restructured services under the LEC price cap plan would

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[21] LEC proposals to remove new services from price regulation entirely are both well outside the appropriate scope of this proceeding and grossly premature, given the limited competition that now exists. *See* Bell Atlantic comments, pp. 19-23.

[22] Haring and Rolfhs, "Comments on Transition Issues," Attachment 1 to Comments of BellSouth at pages 11 (footnote) and 12, stating that the *level* of prices may differ in different segments.

[23] A number of these firms and other firms on the list took charges to reflect the accounting changes for non-pension retirement benefits required by FAS 106, but we excluded these changes wherever they were identifiable (having an average value of about 2.11-cents per share).

remain unchanged, as would the existing Part 69 rate structure rules applicable to existing services. ICA believes that Part 69 rule changes affecting existing services should be evolutionary, as in the development of new rules for transport pricing and the LEC's zone density pricing tariffs. The pace of change in rules for embedded access services can thereby reflect market developments, Commission policy decisions and the most efficient use of Commission resources. Nothing about our proposal for price linking new services would have any effect on the Commission processes under section 214 of the Act,[24] particularly if, as in the case of video-dial tone facilities applications the Commission chooses to utilize the section 214 process to develop specific practices and tests that were not addressed in initial, broader policy pronouncements.

Infrastructure stimulus (Issues 1 and 2)

The Commission requested comments on whether the LEC price cap plan should contain a component or an adjustment to stimulate LEC investment in the telecommunications infrastructure.[25] ICA commented that it would be highly inappropriate for the price cap plan to be converted into some sort of "supply-side" stimulus to the alleged economic development effects of the telecommunications infrastructure. The price cap plan should not contain an explicit infrastructure element. Increased competition will provide a more efficient mechanism for transferring advanced telecommunications and information technologies into the national economy.

The May 9 comments demonstrate overwhelmingly that ICA's position is correct. The LECs' efforts to use promised infrastructure benefits in order to leverage more money for themselves from the price cap plan are quite weak.[26] As discussed below, the "infrastructure spending benefits" that USTA attempted to identify are based upon circular, unsupported, subjective estimates that can be afforded no weight. There are, in addition, many countervailing observations in the comments submitted by customers of LEC interstate access services, both carriers and end users.

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[24] *Cf.*, for example, US West comments at p. 56.

[25] General Issue 1 and Baseline Issue 1.

[26] BellSouth comments, pp. 18-19; Pacific Telesis, pp. 10-13; Southwestern Bell, pp. 4-7 and 67-74; US West, pp. 23-26.

The LECs case for using the price cap plan to generate increased infrastructure investment is founded upon three attachments to USTA's comments; several individual LECs rely upon these papers to mimic USTA's arguments.[27] The WEFA study is simply a "what-if" analysis that is based upon assumptions supplied by other USTA consultants. WEFA does not independently support these assumptions, and it does not purport to. The primary infrastructure stimulus that WEFA used in its aggregate model of the economy to determine the alleged benefits of higher caps is contained on page 24 of the Darby paper in Attachment 3. However, Darby provides no empirical basis whatsoever for the estimated spending stimulus in the 5% to 15% range. The estimate is apparently his own approximation, based upon earlier statements in the paper. These statements are supported almost exclusively by a series of *partial* quotations from reports prepared by securities analysts. Neither quantitative material from these analysts' reports, nor the full text of the reports themselves, are included in Darby's paper. It is very likely that even these research reports were based upon briefings and materials supplied to the analysts by the investor relations departments of various LECs. The Darby paper is entirely anecdotal, non-analytical and non-empirical. The basis for the paper's "conclusions" cannot be determined or replicated.

The WEFA macroeconomic analysis also relies upon Vanston's paper in Attachment 8 to USTA's comments. But Vanston's estimates of increased technological deployment from higher price caps and greater LEC pricing flexibility are apparently rooted in the same investment stimulus that Darby estimated. Vanston notes that WEFA's estimates, Darby's estimates and his own all each "consistent" with each other.[28] Such "consistency" is, however, hardly surprising or noteworthy, because all three papers are related to each other in a subjective daisy chain of unsupported assumptions. In addition, Vanston utilizes "technology substitution curves" to make estimates of how fast technologies will be deployed under the LEC's proposed price cap plan. This technology substitution process has itself been widely criticized and is

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[27] USTA Comments, Attachment 7, The WEFA Group, "Economic Impact of Revising the Interstate Price Cap Formula," Attachment 3, Larry Darby, Price Cap Reform, Financial Incentives and Exchange Carrier Investment," and, Attachment 8, L. K. Vanston: "Accelerating Investment in the Telecommunications Network — Impacts on Technology Adoption and Service Quality."

[28] Attachment 8, pp. 16-17.

not in widespread use as a corporate planning tool today.[29]

Overall USTA's attempt to support relaxation of the price cap plan as a form of supply-side infrastructure stimulus fails.[30] Aside from the ephemeral nature of USTA's own "case" for increased funding, the arguments against converting LEC price caps from a plan intended to protect consumers and control LEC market power to some sort of "supply-side" economy policy for LEC investment, are quite substantial.

ICA noted in our initial comments that, on average for *every month for the last seven years*, the RBOCs have internally generated $90-million that was not re-invested in their networks.[31] Capital formation is not a problem in the LEC industry. Other telecommunications companies, including the major long distance carriers cable television companies and other providers, invest far higher amounts of their available cash flow back into their businesses than do U.S. LECs.

The USTA studies are entirely one-sided, because they do not consider the macroeconomic impact of supposed LEC infrastructure spending if it were in fact retained by the LECs' access customers. The comments of the Ad Hoc Telecommunications Users Committee demonstrate that reducing the consumer savings under the LEC prices cap plan by one-percent [e.g., by reducing the X-factor

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[29] Technology Futures forecasting technique, the "Fisher-Pry model is inherently more adaptable to retrospective analysis than to *ex ante* projections." Fisher-Pry model gives an overestimation of the forecast..." "A Generalized Model for Forecasting Technological Substitution," in Linstone and Sahal, *Technological Substitution: Forecasting Techniques and Applications*, American Elsevier Publishing Company 1976, p. 10; Jones and Twist, *Forecasting Technology for Planning Decisions* (Petrocelli (MacMillan Press), 1978 at pp. 205-206: "The Fisher-Pry must be used with care when forecasting the growth of a new technology. The successful cases quoted in the literature were often reconstructions of historical data benefiting from hindsight-thus they do not illustrate many of the difficulties likely to be experienced when trying to use the technique....The assumption that substitution will proceed to completion may also be questioned....The claim that reasonable forecasts can be made when only a few percentage points have been substituted also deserves to be examined critically. Obviously the longer the history the more accurate are the forecasts likely to be. But how soon can a forecast be made which is sufficiently reliable for planning decisions?"

[30] Interestingly, most of the individual LECs barely discuss these studies. Most do not discuss the Darby and Vanston papers, and discuss the WEFA study only in one or two sentences. *See*, for example, Southwestern Bell comments at pp. 68 and 92.

[31] ICA Initial Comments, Attachment A, p. 2.

from 6% to 5%] for spending on telecommunications investment projects would produce at net *loss to the overall economy* of over $500-million over the following five years.[32] Ad Hoc makes supports this analysis with observations of telecommunications effects on economic development in multiple countries.[33] The infrastructure analysis, moreover, assumes that whatever additional money were captured by LECs through a relaxed price cap *would actually be spent on the LECs' networks*, as they promise.[34]

This assumption is very generous to the LECs, in fact, because all available information shows that regulatory awards of higher earnings, higher earnings and or price cap ceilings, higher depreciation and other sources of increased cash flow do not generally translate into increased LEC investments. A paper prepared by LEC consultants concluded, for example, that different regulatory plans had "no significant effect" on LEC investment levels or technology "diffusion," i.e., the rate at which specific telecommunications technologies like ISDN and Signalling System 7 were installed.[35] They found that "new technology tends to be greatest with flexible pricing and banded ROR [regulatory plans], but the individual effects are generally *not different from one another* when statistical significance is accounted for."[36] Consumer economist Mark Cooper reached quite similar conclusions that "alternative regulation does not have a significant positive effect on technology deployment."[37] LEC investment in technologies like digital switches and ISDN is actually lower under some forms of incentive regulation.

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[32] Ad Hoc Comments, Attachment, ETI Report, "LEC Price Cap Regulation: Fixing the Problems and Fulfilling the Promise, at p. 27.

[33] *See* generally, pp. 12-28. The analysis notes that "government sponsored programs designed explicitly to increase investments in telecommunications infrastructure are likely to form a misguided, imprudent and costly policy." *Id.*, p. 23.

[34] *Id.*. p.27, footnote 39.

[35] T. Tardiff and W. Taylor, "Telephone Company Performance Under Alternative Forms of Regulation in the U.S." National Economic Research Associates (NERA), (Cambridge, MA), September 1993, pages 32-33; noted in MCI Comments, p. 12.

[36] *Id.*, page 35. Emphasis added.

[37] Cooper, ""Milking the Monopoly: Excess Earnings and Diversification of the Baby Bells Since Divestiture," Consumer Federation of America, February, 1994. Appendix A, page 20

Accordingly, there is no basis whatsoever to incorporate an LEC infrastructure spending stimulus in the price cap plan.

LEC productivity (Issue 3)

The LECs' failure to provide any valid evidence in favor of a reduction in the productivity factor designed to stimulate LEC infrastructure development leaves only one real issue with respect to the size of the productivity offset. The primary remaining issue that the Commission must confront with respect to the size of the productivity offset for the LEC price cap plan is whether to give any weight to LEC arguments that Commission must go back several decades in order to discern the appropriate productivity trend. If the Commission gives this LEC argument no weight, as ICA believes it should, then the record of this proceeding is remarkably clear and consistent.

LEC ratepayers have submitted studies based upon both indirect estimates of LECs' achieved productivity (evaluating LEC financial performance and prices relative to economy-wide price changes represented by the GNPPI) and direct measures of actual Total Factor Productivity. The indirect method has been applied strictly to the years since the inception of the LEC plan, by AT&T, and to a longer period of time including the years for which reliable data is available prior to adoption of the plan, by MCI. These methods produce very consistent results. The Ad Hoc Telecommunications Users Committee developed direct TFP data for several LECs and subsequently has shown that TFP input price data withheld by USTA in its May 9 comments produces results highly similar to the AT&T and MCI studies.[38] These results are shown in Table 1 below.

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[38] Ad Hoc Telecommunications Users Committee, "Withdrawal of Motion to Compel," CC Docket 94-1, June 9, 1994. "The data provided by USTA's Response reflects a national LEC input growth rate of only 1.1% or some 2.6% below the GDP-PI rate of 3.7%...supporting an increase in the current 'X factor' to approximately 5.7%...USTA's analysis assumes an annual LEC input price growth rate of 4.6%, substantially higher than the GDP-PI." Withdrawal, p. 2.

Table 1

USTA data with input price adjustment		5.70%
AT&T post price caps study,		
unadjusted for its LEC productivity "reward"	5.97%	
AT&T adjusted for the "reward"		5.47%
MCI study including pre-price cap years, except 1984		5.90%

These values are similar to ICA's initial productivity recommendation in the current proceeding and, equally important, they are very similar to the X-factor values calculated by ICA and other user groups even in 1988-89, during the early stages of the initial development of price caps for LECs. Various calculations of the X-factor advocated by ICA at that time were met with a variety of critiques by LECs and their supporters: Labor factor productivity for LECs, which was in the 5% to 5.5% range even then was not necessarily indicative of total factor productivity, computer-based and integrated circuit technologies were not likely to have the effect on telecommunications productivity that has been persistently observed in the computer industry,[39] the post-divestiture productivity data for LECs should include the first confused and disrupted year of data for 1984 even though statistical tests demonstrated the data point to be an outlier.

The data shown above further contradict all such posturing during the initial development of the price cap plan. ICA might be gratified that the position it first espoused nearly six years ago has been confirmed by contemporaneous data and by improved direct and indirect measures of LEC productivity. Gratification, however, would not alter the fact that over the last several years LEC's ratepayers have paid as much as $1.5-billion too much for interstate services. The cruel fact is this: *The LECs have managed to make far more money by regulatory pressure tactics and gaming the price cap process than they have by developing new and innovative*

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[39] *See* Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Further Notice of Proposed Rulemaking, released April 17, 1989 at paragraphs 696-697. The Commission dismissed ICA's argument to this effect without citing any countervailing data, and indeed, the LECs to this day have never produce any data in either FCC or state regulatory proceedings to refute the determination that computerized technology is having precisely the same productivity-stimulating effects in local telephony as the technology has had in computing.

products, improving the quality of their services or operating more efficiently.

The foundation for the LECs' current efforts to game the productivity offset is again, as it was in 1989 and 1990, the argument that (a) only the long term trend is relevant rather than the more recent trend that incorporates current technological effects, and (b) that the purpose of price caps is to establish a productivity target that reflects "all other firms in the U.S. economy."[40] The full set of data underlying the Christensen study for USTA contradicts both the data used in that study itself and in the anonymous submission by National Economic Research Associates. The LECs' position would have the Commission completely abandon any pretense that LEC price caps is designed to protect ratepayers and provide incentives to individual LECs to maximize their own efficiency using the technology that is available to the local telecommunications industry. The LECs' implication that efficiency incentives will be sufficiently strong if LEC productivity targets are established no higher than the average productivity in overall U.S. manufacturing and service industries simply ignores the effects of the changing technological stock available to LECs.

ICA believes that over time the Commission should give more weight to the direct measures of total factor productivity, but only if the TFP measure accurately accounts for changes in the LECs actual input prices. A direct TFP measure that incorporates broad input cost changes as well as output changes is needed in order to eventually eliminate earnings sharing-type calculations from the price cap plan, but before earnings sharing can be replaced other measures of input costs must be applied by the Commission. The development of an adequate direct TFP measure, that properly accounts for the LECs' input prices rather than relying on a non-specific measure of inflation, would help solve the problem of changes in the LECs' actual cost of capital.[41] Changes in the cost of obtaining debt and equity funds is reflected in the costs faced by LECs in adding to their capital stock.

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[40] *See* USTA comments, Attachment 5 "Economic Performance under the LEC Price Cap Plan (quotation on p. 10); and Attachment 6 "Productivity of the Local Telephone Operating Companies," by Christensen Associates.

[41] Both AT&T and MCI have shown through similar applications of accepted financial analysis techniques that the LECs' current cost of capital is below the 11.25% level embedded in the initial price cap and in the current earnings sharing zones. MCI comments, Appendix A (Kahal Affidavit); indicating a capital cost of 9.54% with an 11.0% return on equity or an overall cost of 10.06% with a one percentage point "adder" to the equity return; and AT&T comments. Appendix D, p. D-5; showing a 1993 cost of capital of 9.33%.

NERA's argument that the use of LEC-specific input prices would reduce LECs' incentives to cut costs should be accorded no weight unless the Commission also finds that both present and future competition is so limited that it will not provide any efficiency incentives to the LECs. Actual measurement of TFP, including input prices, also protects the LECs in the highly-unlikely event that the sustained trends in input prices over the last decade represent some sort of anomaly, as shown by Table 2. NERA's argument that no outside agency routinely measures input

Table 2

	And the FCC uses an	
If the input price differential	**Indirect Measure**	**Direct Measure**
Is Not Sustainable	Consumer, telco interests balanced in the future	Telco X factor declines properly
Is Structural & Sustainable	Telcos receive windfall	Consumer, telco interests balanced

prices is equally unavailing. Christensen's input price data was developed using standardized methods that have been applied in many TFP studies, of telecommunications companies as well as other firms. These analyses do not require the detailed data that price cap LECs already are required to maintain under the Commission ARMIS reporting requirements and Part 64 cost allocation, input prices for capital labor and materials are routinely established for firms and industries that are not subject to such detailed reporting requirements. In any event, the Bureau of Labor Statistics now expects to have completed development of calculations of TFP for the telecommunications industry next year. Therefore, the Commission can begin to develop a transition towards greater reliance on direct TFP measures and reduced reliance upon indirect measures based upon observed LEC prices and earnings.

In the nearer term, ratepayers should receive greater economic benefits from price caps through the an initial rate reduction at the beginning of the second plan period in order to recognize the excessive apportionment of price cap benefits to LECs in the current plan. To compensate for initial mis-specification of the productivity factor, particularly regarding input prices, an initial 3% interstate revenue decrease should be applied to LEC rates. Then, the minimum productivity factor for LECs in the plan should be raised to 5.8% per year exclusive of any additional "consumer productivity

dividend."

Structural features of the LEC plan (Issues 4, 5, and 6)

Structural features of the initial LEC price cap plan include earnings sharing, the common line formula and the treatment of exogenous costs. These features each were developed as ways of checking whether the plan was structured appropriately and struck the correct balance between ratepayers and local telephone companies. Of these three features, the LECs argue most extensively that the current earnings sharing backstop should be eliminated, because it is supposedly a vestige of rate of return regulation and therefore dampens incentives.[42] ICA stated why it is premature to eliminate earnings sharing from the LEC plan in our initial comments, even though we recognize that, in theory, earnings sharing weakens incentives to improve efficiency, all other things being equal.[43] Nothing that the LECs argue regarding the elimination of earnings sharing is persuasive and, if anything, the extensive evidence discussed above that the productivity offset requires a major increase demonstrates that earnings sharing is still needed as a backstop to the LEC plan. There appears to be somewhat greater agreement between the price cap LECs and ratepayer parties that the 50/50 common line formula is now an unnecessary added complexity,[44] and that exogenous cost adjustments should be defined more narrowly.[45]

Service Quality (Issue 7)

In our initial comments, ICA supported the Commission's continuing efforts to monitor and encourage improvements in LEC service quality, through mechanisms such as the pending proceeding in CC Docket No. 91-273 and through the Network Reliability

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[42] Ameritech comments, pp. 14-16; Bell Atlantic, pp. 7-12; BellSouth, pp. 5-7 and 47-52; GTE, pp 69-72; NYNEX, p. 4; Pacific Telesis, pp. 42-49; Southwestern Bell, pp. 46-47; US West, pp. 42-44.

[43] ICA comments, pp. 14-15, and Attachment B.

[44] Ameritech comments, pp. 16-18: GTE, pp. 75-77, Bell Atlantic, pp. 17-18; BellSouth, p. 53; NYNEX, pp. 47-50; Pacific Telesis, pp. 49-52; Southwestern Bell, pp. 48-51; US West, pp. 44-45.

[45] Ameritech comments, pp. 16-17; BellSouth pp. 54-57; Pacific Telesis, pp. 52-55; Southwestern Bell, pp. 51-54. NYNEX continues to argue that GAAP related accounting changes should be treated as current "costs" irrespective of whether they affect actual current cash flow. NYNEX comments, pp. 55-65.

Council (NRC).[46] ICA believes that service quality, network reliability and any associated reporting requirements should continue to be addressed outside of the LEC price cap plan, because incorporating either rewards or penalties for an LEC that exhibited, respectively, either superior or inferior service quality would unduly complicate the plan. The LEC comments generally take the view that there should be no additional monitoring of service quality or how a particular LEC's practices impact service quality.[47] This view, however, is too simplistic. ICA sees telecommunications service quality improving and evolving over time as the "best practices" of the LECs evolve and improve.

The "best practices" can be identified and integrated by all LECs in two ways. First, continuation of the NRC as a forum for exchanging information about service quality deficiencies is important. ICA is heartened that the Commission has extended the life of the NRC and cemented its charter.[48] The mission of the NRC to "evaluate reliability of network services on a local and regional basis...potential new risks from new technologies and to collect data on whether network outages dis-proportionately impact certain geographic areas or demographic groups" is the correct one.[49] That is, the NRC should be a mechanism for uncovering potential problems before they become severe and for identifying and remedying deficiencies in areas or groups. The NRC processes will thereby aid the Commission in placing a "floor" under service quality and network reliability issues.[50]

ICA also believes that the Commission must also provide incentives for LECs to raise the service quality "ceiling," i.e., to ensure that service quality standards and telephone company practices improve over time as more robust and reliable

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[46] ICA Initial Comments, pp. 18-19.

[47] *See* Ameritech comments, pp. 20-21; BellSouth, p. 59; NYNEX, pp. 52-55; Pacific Telesis, pp. 56-59; Southwestern Bell, pp. 59-64; US West, pp. 48-50.

[48] *Public Notice*, "New Members Appointed to the Network Reliability Council," May 12, 1993 (mimeo number 42992).

[49] *Id.*

[50] Some LECs, like NYNEX mistakenly assumed that the functions of the NRC would be absorbed by the telephone company's Alliance for Telecommunications Industry Solutions, formerly the Exchange Carrier Standards Association. NYNEX comments, p. 54 and footnote 129.

technologies are deployed through the public network. These incentives are best achieved by benchmarking the performance of various LECs, publishing service quality monitoring results so that users can evaluate the relative performances of different LECs and the LECs can measure themselves against other telephone companies. ICA agrees with the initial comments of the Tele-Communications Association (TCA), that such benchmarking efforts should be extended to include (1) LEC data submissions identifying their wire centers that are performing in the lower tier of service quality for that particular carrier, and (2) submissions showing LEC performance in the critical parameters of data transmission quality.[51]

Conclusion

In our opening comments, ICA stated that revisions to the LEC price cap plan should seek to better leverage existing market forces applicable to the LECs (like requiring LECs to return to public capital markets for part of their funding of new ventures), and to reflect marketplace surrogates where actual market forces are inadequate. The LECs' own comments pay lip service to competition, but they must in fact try to incorporate the LECs' much broader agenda, which is inherently contradictory.

The major LECs want to be major players in advanced telecommunications, but they also want to continue to be perceived by investors as relatively safe public utilities. As public utilities, they seek to maintain dividends to the parent companies and maintain their cash flow. The cash is then used to diversify into new markets. There are incentives inherent in this posture against the dominant LECs cutting costs beyond the restrictions imposed by the regulatory regime under which they operate. If the LECs can obtain more money through "working" the regulatory process, these incentives will not change for many years. Competition could also create incentives for LECs to cut costs, but again the regulatory process could provide LECs with an unwarranted "safe harbor." The LECs must be able to effectively price discriminate in order to prevent competing entrants from exploiting their high cost structure. They must be able to claim that this activity does not extend to unreasonable price discrimination, but rather reflects their inherent efficiencies compared to the new competitors. On the other hand, in order to maximize overall cash flow, they must continue to try to deny claims that local telecommunications industry as a whole is

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[51] TCA Comments, pp. 5-11.